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In the Supreme Court of the United States

OCTOBER TERM, 1996

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA,
PETITIONER

v.

DONNA E. SHALALA,
SECRETARY OF HEALTH AND HUMAN SERVICES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the Secretary's interpretation of 42 C.F.R. 405.419 (1985), which precludes Medicare reimbursement for interest costs on loans between related organizations, is arbitrary and capricious, an abuse of discretion, or not in accordance with law.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A15) is reported at 82 F.3d 291. The opinion of the district court (Pet. App. A16-A32) is reported at 872 F. Supp. 728. The administrative decision of the Department of Health and Human Services, Provider Reimbursement Review Board (Pet. App. A33-A46) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on April 16, 1996. The petition for a writ of certiorari was filed on July 17, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner filed suit seeking reimbursement for interest costs incurred on loans to three of its university hospitals, the Los Angeles Medical Center, the Irvine Medical Center, and the San Diego Medical Center. All three hospitals are providers under the Medicare program. The Medicare program allows a provider to recover the "reasonable costs" of medical services provided to Medicare patients. 42 U.S.C. 1395x(v)(1)(A). "Reasonable costs" are defined by regulations of the Secretary promulgated at the direction of Congress. 42 U.S.C. 1395x(v)(1)(A); 42 C.F.R. Pt. 405, Subpart D (1985)[1]; see *Thomas Jefferson Univ.* v. *Shalala*, 114 S. Ct. 2381, 2384 (1994) (Section 1395x(v)(1)(A) authorizes the Secretary "to issue regulations defining reimbursable costs and otherwise giving content to the broad outlines of the Medicare statute"). The regulations provide for reimbursement of "[n]ecessary and proper interest" expense. 42 C.F.R. 405.419(a) (1985). "Proper requires that interest [b]e * * * paid to a lender not related through control or ownership, or personal relationship to the borrowing organization." 42 C.F.R. 405.419(b)(3)(ii). "The intent of [the related-party interest rule] is to assure that loans are legitimate and needed, and that the interest rate is reasonable," based on the agency's recognition that a close relationship between the lender and the borrower "could affect the 'bargaining' process that usually accompanies the making of a loan, and could thus be sugges-

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[1] The 1985 regulations govern this case. In 1986, Section 405.419 (1985) was redesignated (without substantial change) as 42 C.F.R. 413.153. See 51 Fed. Reg. 34,790 (1986).

tive of an agreement on higher rates of interest or of unnecessary loans." 42 C.F.R. 405.419(c)(1).

Petitioner made working capital loans to the university hospital providers during Medicare cost years 1982, 1983, 1984 and 1985, and the monies were used for patient care. Pet. App. A4. The loans were precipitated by the hospitals' financial difficulties following a decrease in funding from the state legislature. *Ibid.* The hospital providers' claims for Medicare reimbursement for the interest expenses associated with the loans were denied by the fiscal intermediary under 42 C.F.R. 405.419 (1985). The Provider Reimbursement Review Board affirmed the disallowance of interest expenses. Pet. App. A33-A46. The Administrator of the Health Care Financing Administration declined to review the decision, thus making the Board decision a final agency decision. *Id.* at A47-A48.

2. Petitioner sought review in district court. The district court granted summary judgment in favor of the Secretary. Pet. App. A16-A32. The court of appeals affirmed. *Id.* at A1-A15. The court of appeals concluded that the university hospitals were precluded from receiving Medicare reimbursement for interest expenses on loans from petitioner based on 42 C.F.R. 405.419 (1985), which disallows reimbursement of interest costs from loan transactions between related entities. The court of appeals held that Section 405.419 established a general rule of non-reimbursement, and it rejected petitioner's argument that the related-party interest rule did not apply if the loans were legitimate and necessary and the interest rate was reasonable. Pet. App. A7. The court also held that petitioner lacked standing to challenge the constitutionality of an exception to the related-party

interest rule, 42 C.F.R. 405.419(c)(2) (1985), which allows Medicare reimbursement of interest expenses where the provider borrows from a related religious order. Pet. App. A12-A15.[2]

ARGUMENT

The decision below is correct and does not present a conflict calling for this Court's plenary review.

1. Petitioner principally relies on the decision of the Court of Claims in *Trustees of Indiana Univ.* v. *United States*, 618 F.2d 736 (1980) (Pet. App. A55-A65), which held that Section 405.419 could not be read literally to disallow a university hospital provider to obtain Medicare reimbursement for interest payments on loans it received from the university. Pet. App. A62-A63. The court limited its holding to the "particular circumstances of [that] case—where the nonprofit hospital is affiliated with a State university, the State appropriates no money for the hospital, the hospital is prohibited by State law from borrowing from outside sources, and the university lends the hospital essential funds at less than the current rate of interest." *Id.* at A64.

The Ninth Circuit distinguished the *Indiana* decision on two grounds. Pet. App. A8-A9. First, the hospital providers in *Indiana*, while a part of the University medical center, were separate state institutions and had never received state funding. In contrast, the University of California hospital providers have received state funds in the past. Second, state law in

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[2] The court of appeals also rejected petitioner's argument that Section 405.419 created an irrebuttable presumption in violation of its due process rights. Pet. App. A10-A12. Petitioner does not advance that argument in its petition for certiorari.

Indiana prohibited the hospital providers from receiving state funds. California has no such law. Thus, the court of appeals concluded that "the only way for the hospital in *Indiana* to obtain operating funds was through the University." *Id.* at A9.

In emphasizing the limited scope of its decision, the *Indiana* court explained that it was "not holding that interest payments to a related person are reimbursable wherever the particular relationship does not involve any of the evils against which the regulation is directed." Pet. App. A64. Moreover, the court stated that it did not intend to cast "any doubt upon the authority of the Secretary to adopt his prophylactic regulation generally barring reimbursement of interest payments to related persons, without inquiry into the particular circumstances." *Ibid.*

To the extent that *Indiana* and the decision below are in any tension, *Indiana* is aberrant. Indeed, after *Indiana*, the Court of Claims upheld the general bar against reimbursement of interest from related-party loans in *Jackson Park Hosp. Found.* v. *United States*, 659 F.2d 132, 137-138 (Ct. Cl. 1981). In any event, the Federal Circuit and the Claims Court, which replaced the Court of Claims, no longer have jurisdiction to review reimbursement denials under the Medicare program. See 42 U.S.C. 1395*oo*(f)(1); *St. Vincent's Med. Ctr.* v. *United States*, 32 F.3d 548, 551 (Fed. Cir. 1994); *St. Luke's Med. Ctr.* v. *United States*, 22 Cl. Ct. 322, 329 (1991).

Nor does the decision below conflict with the other decisions cited by petitioner (see Pet. 9). The Sixth Circuit in *Shaker Med. Ctr. Hosp.* v. *Secretary of Health & Human Servs.*, 686 F.2d 1203, 1207-1210 (1982), and *University of Cincinnati* v. *Heckler*, 733 F.2d 1171, 1174-1177 (1984), upheld the validity of

Section 405.419 and denied recovery of interest costs. *Northwest Hosp., Inc.* v. *Hospital Servs. Corp.*, 687 F.2d 985, 990-996 (7th Cir. 1982), involved quite different circumstances; the court there held that the hospital provider could recover interest expenses resulting from loans made by related parties for the purpose of converting the hospital from a profit to a non-profit institution.

Petitioner's argument that Section 405.419 should not have been applied because the purposes of the regulation were not served in this case is inconsistent with the plain language of the regulation, which prohibits reimbursement of interest incurred on debt where the lender is "related through control, ownership, or personal relationship to the borrower." 42 C.F.R. 405.419(c)(1). For petitioner to fault the agency for literally interpreting that regulation stands this Court's long-standing deference to an agency's construction of its own regulation on its head. For instance, in *Thomas Jefferson Univ.* v. *Shalala*, *supra*, the Court upheld the Secretary's interpretation of 42 C.F.R. 413.85(c) (1993), which set forth "a bright line for distinguishing permissible from impermissible reimbursement" of hospitals for certain educational expenses. 114 S. Ct. at 2389. The Court noted that "[w]e must give substantial deference to an agency's interpretation of its own regulations" and that "[o]ur task is not to decide which among several competing interpretations best serves the regulatory purpose." *Id.* at 2386.

As in *Thomas Jefferson Univ.*, the Secretary reasonably interpreted the plain language of Section 405.419 to create an irrebuttable presumption against reimbursement of interest expense from related-party loans. As the court of appeals observed, adop-

tion of petitioner's position would encourage nonprofit organizations that provide operating funds to hospitals "to recharacterize routine, operating capital allocations as 'loans' in order to take advantage of the interest expense reimbursement policy of Medicare." Pet. App. A10. Also, the position urged by petitioner would necessitate the administratively burdensome "case-by-case review the regulations were deigned to avoid." *Ibid.* The court of appeals therefore correctly held that "Congress did not require the Secretary to make exceptions to its policy on related party loans for arguably meritorious transactions involving a specific type of related party." *Id.* at A9. This Court, too, has upheld the validity of prophylactic regulations like Section 405.419. See *Mourning* v. *Family Pubs. Serv., Inc.*, 411 U.S. 356, 373 (1973) ("Since the deterrent effect of the challenged rule clearly implements the objectives of the Act, respondent's contention is reduced to a claim that the rule is void because it requires disclosure by some creditors who do not charge for credit and thus need not be deterred. The fact the regulation may affect such individuals does not impair its otherwise valid purpose."); see also *Weinberger* v. *Salfi*, 422 U.S. 749, 776 (1975) (Although the statute's conclusive presumption "doubtless proves in particular cases to be 'under-inclusive' or 'over-inclusive,' in light of its presumed purpose, it is nonetheless a widely accepted response to legitimate interests in administrative economy and certainty of coverage for those who meet its terms.").[3]

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[3] Petitioner's further contention (Pet. 19-20) that an irrebuttable presumption is inconsistent with the Medicare Act because it may shift Medicare costs to individuals not covered

4. Section 405.419 sets forth limited exceptions to the related-party interest rule, one of which allows for reimbursement of interest costs in cases in which the provider borrows from a related religious order. 42 C.F.R. 405.419(c)(2) (1985). Petitioner argues (Pet. 14-19) that this exception constitutes an unconstitutional preference for religion in violation of the First Amendment's Establishment Clause, but that if Section 405.419 is construed to create only a rebuttable presumption of non-reimbursement, "the constitutional difficulties resulting in the regulation are mitigated." Pet. 15.

However, Section 405.419 is neither ambiguous nor reasonably susceptible to petitioner's interpretation with respect to hospitals generally. Nor would this case be a proper vehicle in which to adjudicate the constitutionality of the exception in Section 405.419(c)(2) for hospitals related to religious orders because, as the court of appeals observed, petitioner conceded below "that it was not challenging the constitutionality of the regulation or the exception." Pet. App. A13; see also Pet. 16 ("[I]t is Petitioner's position that the court, *sua sponte*, should interpret the regulation in question so as to avoid any unconstitutionality under the establishment clause."). Moreover, neither the court of appeals nor the district court addressed the merits of petitioner's argu-

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by Medicare similarly fails. The Medicare Act vested the Secretary with broad authority to define reimbursable "reasonable costs," 42 U.S.C. 1395x(v)(1)(A), and, for the reasons set forth above, Section 405.419's preclusion against interest from related-party loans is a reasonable implementation of the Act. See *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1735 (1996).

ment,[4] and there is no conflict among the courts of appeals on the issue.[5]

5. In any event, the interest rule in Section 405.419 has little continuing significance for most hospitals. The Social Security Amendments Act of 1983, 42 U.S.C. 1395ww, generally replaced the "reasonable costs" system of reimbursement with a Prospective Payment System. See *Good Samaritan Hosp.* v. *Shalala*, 508 U.S. 402, 406 n.3 (1993). Effective for cost reporting periods beginning on or after October 1, 1991, the payment methodology for hospital capital costs, such as interest, is governed by the Prospective Payment System, under which payment rates are established with declining regard to the hospital's current "costs" of capital. See 42 C.F.R. 412.304(a) (1996).[6] Under that system, therefore, it is generally

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[4] The court of appeals held that the petitioner lacks standing to challenge the constitutionality of Section 405.419(c)(2) because petitioner has not shown how it is injured by the exception for religiously affiliated providers, and because if the exception were stricken, petitioner would still be subject to the non-reimbursement rule in Section 405.419. Pet. App. A13-A15; see also *Massachusetts* v. *Mellon*, 262 U.S. 447 (1923).

[5] The *Indiana* decision did not adjudicate the validity of Section 405.419(c)(2) but merely noted that a non-literal interpretation of the regulation obviated the need to address the court's concerns about the exception's constitutionality. Pet. App. A63.

[6] Section 412.304 provides for a ten-year transition period, scheduled to be completed by October 1, 2001, during which "the capital payment amount is based on either a combination of payments for old capital costs and new capital costs or a fully prospective rate" that, over the transition period, is based less and less on the individual hospital's actual cost of capital. 42 C.F.R. 412.304(b); 412.340.

irrelevant whether a hospital secures its financing for capital projects from a related party.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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